No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. Gordon Phillips and Lauretta M. Phillips,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

REPLY BRIEF OF THE PETITIONERS.

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ARGUMENT.

I.

The Tax Court Erred in Entering Separate Decisions Against Each Petitioner for the Full Amount of the Asserted Deficiency for the Calendar Year 1951.

Respondent at the conclusion of its brief states that the decisions of the Tax Court should be affirmed. Regardless of the merits of this case, and assuming this Court were to agree with the opinion of the Tax Court, the decisions entered therein should none the less be modified.

Petitioners filed a joint federal income tax return for the year 1951. There should have been only one petition filed in the Tax Court. However, separate petitions were filed for the husband and for the wife. The Tax Court,

having decided in favor of the Respondent thereupon entered a separate judgment in each proceeding in the full amount of the deficiency, to-wit, $15,525.59.

Obviously the agents of the Commissioner of Internal Revenue, having two separate judgments for $15,525.59 each, will be obligated to collect the full amount of each judgment, or a total of $31,051.18, unless the order is modified. No appeal bond was filed in this proceeding, and counsel has been advised that collection agents have been attempting to collect the full amount of the deficiency from each spouse. If the opinion of the Tax Court were to be adopted, the decision of that Court should be modified to provide for a single judgment against both taxpayers for the amount of such deficiency.

II.

The Tax Court Erred in Holding Taxpayer Received the Proceeds of Sale of the Stock Without Restriction as to the Disposition of the Proceeds.

Respondent has failed to refute the arguments of taxpayers that the sales proceeds received in 1951 were received subject to a contractual restriction. In this case taxpayer, prior to the sale in question, had entered into an agreement with Raichart to the effect that 320 of the shares sold were owned by him. This agreement, although contested by taxpayers, was at all times in full force and effect and was upheld in the California courts. As a condition precedent to his right to the sales proceeds, taxpayer was required to invalidate this agreement. He was unable to do so. The cases cited by Respondent (Br. 11) all involve what might be referred to as conditions subsequent. In *North American Oil v. Burnet*, 286 U. S. 417, the money was paid over to the taxpayer by the

receiver pursuant to the judgment of the lower court. It properly belonged to the taxpayer at that point, subject only to a possible reversal of the decision upon appeal. For the year in question it had been held by the court that the taxpayer was entitled to the money. The same was true in *Phillips v. Commissioner,* 25 T. C. 767, affirmed 238 F. 2d 473 (C. A. 7th), which involved a contingent fee. He won the case in the lower court and received his fee. Later the decision was reversed, and the attorney was forced to return the fee. In *Rutkin v. United States,* 343 U. S. 130, the extorted money was never returned at all, nor was there any inference that it ever would have been. This argument was raised by the taxpayer merely by way of a possible defense in his tax case.

In the case before this Court the taxpayer by contract had agreed that the 320 shares of stock belonged to Raichart. The proceeds received on their sale likewise belonged to him. It is true that taxpayer endeavored to avoid the contract, but to no avail. If A borrows money from B he does not realize income upon the receipt of the loan because of his obligation to repay. A may of course breach his agreement and refuse to repay. However, counsel knows of no case holding that A realizes income merely as a result of such breach. He may of course realize income if B forgives the debt or fails to enforce his rights within the applicable period of limitations. Here, however, the executrix of Raichart's estate instituted prompt legal action to enforce the contract [Resp. Exs. D and F].

In *St. Regis Paper Co. v. Higgins,* 157 F. 2d 884, cited by Respondent (Br. 15) a corporation received dividends from its wholly owned subsidiary and paid tax thereon. The dividend was later rescinded and the money

repaid to the subsidiary because the dividend was in violation of an indenture agreement. However, there was nothing illegal about the dividend. The declaration and payment merely gave the indenture trustee the express remedy of acceleration of the payment of principal and interest on debentures covered by the agreement. By way of dictum the court stated that assuming the taxpayer could have been held liable as a constructive trustee, the declaration of the dividend violated no law and at most the payment was the breach of a private contract. In the case before this Court the taxpayer wrongfully converted the property of another. Conversion involves a tortious act—some act of ownership or exercise of dominion over the property of another in defiance of his rights.

Similarly in *United States v. Lesoine,* 203 F. 2d 123, also cited by Respondent (Br. 15) and decided by this Court, involved dividends paid in one year to the two stockholders of a California corporation with the dividend being rescinded in the following year. The corporation had no book surplus at the time the dividends were paid, but it did have "earnings or profits" for payment of dividends within the meaning of Section 115(a) of the Internal Revenue Code of 1939. These earnings remained intact and were available for the distribution of the dividends in question.

III.

The Tax Court Erred in Not Taxing the Gain Realized on the Sale of the Stock to the Owner Thereof as Determined by the State Court in an Adversary Proceeding.

Respondent has not been able satisfactorily to distinguish *Estate of Bluestein v. Commissioner,* 15 T. C. 770 from the facts of this case. It will not suffice merely to point out that estate tax as well as income tax was there involved (Br. 13-14), nor merely to state that *Freuler v. Helvering,* 291 U. S. 35, controlled the includibility of assets in the estate. The fact remains that the decedent had claimed the income from property owned by others as his own up to the time of his death. The judgment of the state court determining property interests was entered in the year following death. Respondent maintains that no events that occur subsequent to the accounting year can ever be accorded any recognition in a case such as this. Yet the Tax Court in *Bluestein* did in fact tax the income to the owner of the property on the basis of the subsequent determination.

Respondent cites *United States v. Lewis,* 340 U. S. 590 (Br. 14), for the proposition that the "claim of right" doctrine has not been impaired by *Freuler v. Helvering,* 291 U. S. 35, as stated by the Court of Claims. Counsel does not contend to the contrary. Nevertheless, in that case (91 Fed. Supp. 1017) the Court stated at page 1021:

> "* * * The fact that the court so interpreted the statute [in *Freuler v. Helvering, supra*] as to make taxability depend upon the outcome of litigation as to whether the beneficiaries actually receiving the income were legally entitled to keep it or not seems to us to discount very heavily the idea that the finances

> of the nation would be thrown into disorder if the Government were allowed to tax as income only that which is, in fact, income to the taxpayer, and not that which only seems to be income because he is mistaken as to his right to keep it."

Evidently Congress also felt that the nation's finances could survive without the necessity of applying the unnecessarily harsh and inflexible mechanical rule enunciated in the *Lewis* case. See Section 1341 of the Internal Revenue Code of 1954.

The doctrine of the *Lewis* case should not be applied to the case before this Court unless it appears that the facts bring it squarely within that rule. It is submitted that they do not. The *Lewis* case involved the question whether a bonus should be computed on net profits before or after deduction of taxes. This case involves the wrongful conversion of the property of another and is much more similar to the facts of the *Bluestein* case than to those of the *Lewis* case.

IV.

All Relevant Facts and Circumstances Must be Considered.

Without repeating the arguments under this heading in petitioners' opening brief, it should none the less be pointed out that cases such as *United States v. Iozia,* 104 Fed. Supp. 846, cited by Respondent (Br. 15) involve prosecution for the filing of false and fraudulent returns. The defense in each instance is that the money in question does not represent income because stolen from another. This was also substantially the situation in *Rutkin v. United States,* 343 U. S. 130. Obviously the Courts, confronted with such a facutal situation, are

going to limit the rule of *Commissioner v. Wilcox,* 327 U. S. 404, to a clear case of no realizable gain. To do otherwise would make crime pay with a vengeance.

In the case here before this Court, however, the situation is entirely different. Taxpayer paid the tax on the entire gain realized on the sale of all the stock in 1951. The tax was paid not only on the gain attributable to taxpayers' stock but also on the stock owned by another. Tax presumably has also been collected from the owner of that stock. The Treasury is not being asked to assess the relative merits of the respective claims of the two owners or to withhold the collection of any tax pending the outcome of litigation. All that is here in issue is the correct amount of tax owed by petitioners for the calendar year 1951. The correct amount of capital gain which should be taxed is the gain on the stock owned by these taxpayers exclusive of the gain realized on the stock owned by a third party as determined by the California courts. This Court is asked to so hold.

CONCLUSION.

The decisions of the Tax Court should be reversed. If not reversed, they should be modified as to provide for one joint and several judgment in the amount of the deficiency rather than two separate judgments, each in the full amount of the deficiency.

Respectfully submitted,

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